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SUBJECT: SERBIA: UNCERTAIN RELATIONSHIP WITH GAZPROM

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#### SUMMARY

1. (SBU) Serbia's energy marriage with Gazprom centered on the sale of state oil firm NIS at the beginning of this year had a rocky start and Serbs are increasingly unsure how Gazprom's interests fit with Serbia's. Gazprom's initial actions since taking over NIS raise questions about the company's plans in Serbia and the company's role in the economy. The Serbian government's relationship with Gazprom is already under stress following Gazprom's demand for payment of long-standing debts owed by state-owned firms and a dispute over whether NIS made a profit in 2008. End Summary.

#### UNCERTAINTY ABOUT RUSSIAN PLANS

2. (SBU) During the Ambassador's March 19 visit to Pancevo, Srdjan Mihajlovic, director of state-owned oil-pipeline company Transnafta, told us that he was not aware of any of Gazprom's plans for NIS and strategies for the future, even though the firm is Transnafta's dominant customer. Pancevo petrochemical firm HIP Petrohemija director Slobodan Adzic said that he recently had tough talks with NIS's new management where they pressed for payment of \$100 million debt to NIS. NIS has a 19.8% ownership stake in the majority state-owned HIP. HIP's relationship with NIS is critical as NIS's refinery located directly across from HIP in Pancevo and is the firms' primary supplier.

#### DISPUTE OVER NIS PROFIT

3. (SBU) In addition to uncertainty about Gazprom's plans, the Serbian government disputes Gazprom's assertion that the firm did not earn a profit in 2008. At the end of February 2009, NIS submitted to the Ministry of Finance a final account for 2008 approved by the previous NIS management with a profit of \$34 million. However, several days later, the new Gazprom management asked for additional time to review the firm's books and submitted a new final account for 2008, signed by the new director Kiril Kravchenko, claiming losses of \$55 million in 2008. According to the NIS sale contract, the Serbian government would receive 15% of NIS's annual profit during the next four years.

4. (SBU) Ljubica Simic, NIS Corporate Director for Development and Investments, told us on March 12 that NIS had huge losses due to differences in prices of crude oil and derivatives in the last quarter of 2008. She also said that Gazprom would not tolerate further non-payment from Serbian state-owned companies. Milos Saramandic, the general director of NIS before the Gazprom takeover, told us on March 17 that the new NIS management did not consult the

NIS managing board before sending the new final accounting for 2008 with a loss.

15. (U) According to the press, Gazprom was angry at a decision just before Gazprom took over NIS to return some \$100 million from NIS profits from previous years to state-owned NIS debtors, including airline JAT, gas company Srbijagas and roads firm Putevi Serbia in order to cover debts to NIS. One of the Russian members of the NIS managing board pressed charges in the Novi Sad Commercial Court to annul that decision. Gazprom will have international auditor KPMG review the final accounting for 2008 by the end of June 2009. In addition, Gazprom temporarily blocked all payments to local NIS customers to review all financial transfers. Talks between the Government of Serbia and Gazprom to resolve the profit issue started on March 19.

NO COMMON LANGUAGE  
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16. (SBU) Ljubica Simic told us that she had expected the new Gazprom management to dismiss her and her colleagues in NIS's finance and investment departments. Currently, several dismissed NIS directors are working as consultants on short-term contracts. Simic questioned the expertise of some new Gazprom colleagues. Her likely replacement would be a young German philosophy graduate without any expertise in oil or refining. New Russian Gazprom management and engineers had difficulty communicating since the Russians did not speak English or Serbian and Serbian managers and engineers did not speak Russian. She described the atmosphere in the company as confused and uncertain. According to Simic, she saw no clear strategy for the future and for investment from the new leadership.

UNCERTAIN INVESTMENTS  
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17. (SBU) Simic said that Russians were hit by the global crisis and they are looking for financial options to cover NIS's \$760 million investment obligations. Aside from the required investments Gazprom was reviewing all NIS's investment plans for 2010. Simic admitted that NIS's plans were always overestimated. NIS had announced tenders for the modernization of the company's refineries as envisaged by the purchase contract but Simic said the tenders might never go beyond announcement. Simic explained that the formulation of the contractual investment provisions in the purchase contract allowed for flexible interpretation (i.e. Gazprom was contractually required to announce the tenders, but not to complete them). She said that there was significant interest in the plant modernization tenders, including from the Czech affiliate of the U.S. firm CB&I (Chicago Bridge and Iron). CB&I had an Engineering, Procurement, and Construction (EPC) contract for the modernization of a refinery in Rijeka, Croatia. Simic did not expect better quality gasoline from the plant modernizations before 2012 and expected that NIS would import EURO5 standard gasoline if the government lifted the gasoline import ban in January 2011 as planned.

COMMENT  
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18. (SBU) Just a few months into Gazprom's takeover of NIS, Serbia is confronting Gazprom's opaque tactics and single-minded pursuit of profit. There are questions about the firm's plans for NIS's future and the role Gazprom will play in the Serbian economy in the future. Rumors about Gazprom's next move are the latest craze, with speculation ranging from Gazprom will cannibalize NIS of its all its assets over the next few years to claims that Gazprom will leverage the debts owed by state firms to take ownership of HIP or JAT. While political motivations drove the energy agreement that sold NIS to Gazprom, the economic reality of that choice are only now beginning to fully hit Serbia. While our message over the last two years to the Serbian government and local business leaders that increasing Serbia's energy dependence on Russia was not a recipe for increasing energy security fell on deaf ears, we are using this opportunity to highlight with our interlocutors the risks of

Serbia's current strategy. While the NIS deal is done, final arrangements to give Gazprom control over the Banatski Dvor gas storage facility remain uncompleted and the recently announced power plant tenders offer an opportunity for Serbia to seek greater diversity in energy partners and increase energy security. End Comment.

MUNTER